

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Rod Pacheco Analyst: Kimberly Pantoja Bill Number: AB 1320
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 02/23/2001
Attorney: Patrick Kusiak Sponsor: FTB

SUBJECT: Penalty For Failure To File A Return Upon Notice And Demand With Respect to Individuals

SUMMARY

This bill would change the calculation of the penalty for individual taxpayers who fail to file an income tax return after FTB sends them a written demand to file.

PURPOSE OF THE BILL

This bill is sponsored by the Franchise Tax Board (FTB) to reduce, or in some cases eliminate, the demand penalty for individual taxpayers who currently incur a penalty even though, due to timely estimate payments and tax withholding, the taxpayer had no actual tax liability.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2002, and operative for penalties imposed on or after January 1, 2002.

POSITION

Support.

At its December 18, 2000, meeting, FTB voted 2-0 to sponsor the language introduced in this legislation.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law imposes a failure to file penalty of 5% of the amount of tax required to be shown on the return (less any earlier payments and credits) for the first month. An additional 5%, but not to exceed a total of 25%, is added for each month (or fraction of a month) that the failure continues without reasonable cause. There is a minimum penalty for failure to file any income tax return within 60 days of the due date (including extensions), except if the failure was due to reasonable cause and not willful neglect. This minimum penalty is the lesser of \$100 or the amount of tax required to be shown on the return.

Board Position:

<u> X </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Alan Hunter for GHG

03/30/01

Existing state law authorizes FTB to make notice and demand on an individual taxpayer for whom FTB has no record of a tax return having been filed for a particular taxable year. For individual taxpayers, FTB implements this statute by issuing a notice and demand letter directing the taxpayer to file their return within 30 days, provide a copy of the return if previously filed, or state why they are not required to file a return.

If the taxpayer fails to comply with the notice and demand letter as directed, a Notice of Proposed Assessment (NPA) will be issued to the taxpayer. Typically the NPA will propose to assess tax based on information available to FTB (usually federal information) and impose a late filing penalty. In addition, the NPA will propose to impose a "demand penalty" for the taxpayer's failure to comply with the notice and demand letter. The demand penalty is 25% of the taxpayer's total tax-before applying any timely payments or withholding credits.

There are limited exceptions to the imposition of the demand penalty. It is not imposed if the notice and demand letter is undeliverable because of an erroneous address. If the address is incorrect, department staff attempts to identify a current address and, upon doing so, reissues the notice and demand letter. Also, this penalty may not be imposed if it is determined that the taxpayer's failure to comply with the notice and demand letter was due to reasonable cause and not willful neglect.

Imposition of the "demand penalty" in connection with failure to comply with the notice and demand letter may cause a taxpayer to incur a penalty even though, due to timely payments and withholding, the taxpayer had no actual tax liability due and payable.

THIS BILL

This bill would change the calculation of the 25% demand penalty with respect to individuals to calculate the penalty on the basis of the tax liability, after allowing credits and withholding, rather than on the basis of total tax before allowing credits and withholding. This bill would impose the penalty only on taxpayers who both owe tax and fail to file a return when requested. Taxpayers entitled to a refund upon filing their tax return would not owe the penalty.

IMPLEMENTATION CONSIDERATIONS

This bill would change the manner of calculating the penalty for failure to file upon notice and demand with respect to individuals; however, the department's procedures regarding when the penalty would be imposed would remain the same.

Currently in filing enforcement situations, an NPA is issued within 50-60 days after the issuance of the notice and demand letter for a missing return. The manner in which the penalty is calculated is shown as part of the NPA. This conforms to the department's policy of advising taxpayers at the earliest opportunity regarding proposed assessments.

Under this bill, the notice and demand letter would advise the taxpayer that if a return or an explanation of why a return is not required is not filed within 30 days, the demand penalty will be imposed. Additionally, for individuals, the letter would state that the demand penalty will be calculated after allowing for credits and withholding. This bill would require changes to the department's systems to recognize that the penalty will be imposed after credits and withholding. The changes needed are estimated to be moderate.

LEGISLATIVE HISTORY

AB 296 (Strickland and Kaloogian, 1999/2000), with the same language as contained in this bill, was held in the Assembly Appropriations Committee.

PROGRAM BACKGROUND

The penalty for failure to comply with a notice and demand letter has been criticized as excessively harsh since the taxpayer is subject to a penalty of 25% of the total tax liability without reduction to reflect payments, withholding, and other credits. The penalty is imposed even when a taxpayer is due a refund if they had filed their return timely.

At its meeting on September 19, 2000, the Franchise Tax Board approved a policy change regarding imposition of the demand penalty. The Board's policy now requires that a demand letter be sent to repeat nonfilers only. Taxpayers who did not file timely but have filed timely for the previous four years will receive a reminder letter instead of a demand letter. When an assessment is issued in these cases, a demand penalty will not be added. The automated system will be programmed to identify the taxpayers that have a history of repeated nonfiling so that demand letters are sent to that group only. This change in policy was implemented for any demand letters issued after January 1, 2001.

OTHER STATES' INFORMATION

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws.

Illinois imposes a demand penalty equal to the greater of \$250 or 2% of the tax shown on the return, without regard to any payments or credits. The penalty may be assessed up to a maximum of \$5,000. This penalty is assessed even if there is no tax liability due. This penalty is imposed if a return is not filed within 30 days of a notice of nonfiling.

Massachusetts allows taxpayers 30 days after a written notice of failure to file has been issued, then may assess a demand penalty of up to double the tax amount determined to be due without regard to any payments or credits.

Michigan adds a demand penalty of 5% of the tax due every month until the taxpayer files and pays. The maximum penalty is 50% of the balance of tax due. The minimum penalty is \$10 for the first month.

Minnesota imposes a late filing penalty of 10% of the unpaid tax on individual income tax returns filed more than six months past the due date of the return, but does not have a penalty equivalent to the demand penalty contained in this bill.

New York imposes a penalty equal to the total amount of the tax not collected on any person who willfully fails to pay the tax due, but does not have a penalty equivalent to the demand penalty contained in this bill.

FISCAL IMPACT

This bill is not expected to impact the department's costs significantly.

ECONOMIC IMPACT

Tax Revenue Estimate

The penalty impact of this bill is estimated to be as follows:

Estimated Revenue Impact For Penalties Imposed After January 1, 2002 Fiscal Year Impact			
2001-02	2002-03	2003-04	2004-05
-\$2	-\$7	-\$8	-\$8

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Estimate Discussion

Estimates are based on actual assessment data and information from the department's filing enforcement program. It is not anticipated that this change would significantly alter current payment patterns and responses of taxpayers.

ARGUMENTS/POLICY CONCERNS

Imposing the penalty after allowing for credits and withholding would result in a smaller penalty amount for taxpayers who have had withholding or credits and eliminate the penalty for those taxpayers who are owed a refund.

Calculating the penalty for individuals for failing to file a return at 25% of tax after withholding and credits are taken into consideration would be a more reasonable penalty. The 25% demand penalty for individuals would be imposed only on the amount of additional tax due. This bill would address the concerns voiced by the tax practitioner community, taxpayers, and media regarding the harshness of the current penalty calculation.

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